OPEB: Dealing with the Elephant in the Room Creates Opportunities for Actuaries

by Michael L. Frank

About the Author: Michael L. Frank, is president of Aquarius Capital, an organization that provides customized solutions in finance, insurance, and risk management in the life, accident and health insurance fields. He has 20 years of experience in retiree benefits including valuing, designing and securitizing benefits including retiree benefits.

With municipalities, school districts, state/local governments, and other public entities dealing with the day to day struggles of managing their business. OPEB, which stands for Other Post Employment Benefits, is becoming an increasing issue to deal with. OPEB deals with the promise of providing coverage for post employment non-pension benefits such as healthcare and life insurance. This obligation is more than hundreds of billions, maybe a trillion dollars in this country, and has been relatively ignored. Actuaries will be needed to value this liability and may also provide services (e.g., consulting, products) to address this issue.

With the recent requirements of Government Accounting Standards Board No. 43 and 45, public entities are now forced to value and recognize that this obligation exists, a challenge and political nightmare from entities that are dealing with other challenges in their local community. If you are in a community experiencing rising taxes and raising of school district construction bonds to pay for upgrade of your schools, then the thought of your school district or local government having to recognize an obligation of tens to hundreds of millions is horrifying. This may be the largest liability that your local government and school district has to deal with.

The challenge for these entities is that these obligations have always been there or at least have been there for a long time through promises provided to employees when they retire and through collective bargaining. This is not a new issue, since traditionally large single employers have been recognizing today this OPEB under Financial Accounting Standards Board Statement No. 106.

When will this happen? Over the next three years, public entities will be valuing and recording these liabilities. They will be hiring actuarial consulting firms to do these calculations. Entities with revenue of more than $100 million will be recognizing first, while entities with revenue under $10 million will be required to recognize these obligations by the third and final year of required implementation. Many of these organizations have already started the process of valuing this for both accounting and for management purposes since they want to both prepare for the bad news and well as required when applying for loans and bonds. The debt market and rating agencies are keenly aware of this issue and are requiring these items to be valued for entities that are applying for debt instruments.

The first step to solving the problem is recognizing the problem. Administrators, politicians and public entities are going to have to accept, whether they like it or not, that this is an issue. Once this is accomplished, then solutions will need to be made. Putting your "head in the sand" strategies of ignoring this problem can no longer be solved. America is aware of the healthcare issues today with increasing costs for healthcare with individual coverage potentially more than $4,000 per year and family coverage greater than $12,000 per year. With inflation (healthcare cost inflation or trend) growing in double digits, this complicates things further since future costs will be significantly greater than current cost.

What has traditionally been done with OPEB? For the traditional public entity, these costs have been valued on a pay-as-you-go basis recognizing and budgeting costs as dollars are being spent. This approach unfortunately does not value the impact of vesting benefits for current active employees that are earning these retirement benefits nor is it reflecting the impact of inflation on this benefit. A public entity that spends $5 million a year in retiree benefits may have a liability more like $50 million to $100 million.

This issue is not a completely new issue, since employers in the private sector had to value these benefits previously. This was done in the early to mid 1990s under Financial Accounting Standards Board Statement No. 106 (FAS 106). However, the obligations of those organizations in most cases did not have the same magnitude as anticipated for

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public entities under GASB 43 & 45. (Most companies that reflected FAS 106 recognized this liability as one of the largest obligations on their company, so it's still an issue for the private sector.)

The reason the FAS 106 liabilities, which are very large, were not as large as anticipated under the GASB 43/45 liabilities is that retirement benefits offered in the private sector were less generous and in most cases dealt with benefits for individuals receiving benefits after age 65 whereby these benefits were secondary coverage behind Medicare.

However, in the public sector, benefit eligibility may be much earlier, and individuals will be eligible in their 50s, or in some cases 40s (benefit eligibility may kick in at 20 to 25 years of service regardless of age), meaning that they could be receiving benefits 10 to 20 years prior to Medicare kicking in. Individuals in the public sector traded greater pay for richer retirement benefits. As a result, the magnitude of these OPEB liabilities, which would be valued as the present value of future benefits less the present value of future contributions (contributions made by the retirees), will be much greater. As an example, an employer may have an actuarial liability of 10 to 20 times their current pay-as-you-go number. The magnitude is material.

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What are the key buzz words in GASB 43/45? Some of the keys terms are the Annual Required Contribution (ARC) and Unfunded Accrued Liability (UAL). The ARC is the employer's periodic contribution to the defined benefit OPEB plan, which reflects the service (normal) cost for benefits earned during the year plus the amortization of the prior liability earned prior to the initial implementation of GASB 43/45.

The UAL is the excess of the accrued liability of benefits, which would be the present value of future benefits less future contributions accrued and earned to date, above the assets funded for the plan. In many cases, these asset amounts are zero except in cases whereby entities were required to fund benefit due to collective bargaining purposes. The ARC and UAL are valued by actuaries. However, the most important take away for a reader is that these numbers are material and greater than the costs reported today, which is on a pay-as-you-go basis.

An important thing to know about GASB 43/45 is that it establishes standards for accounting and financial reporting. The decision and level of funding is determined by the public entity itself.

What other issues exist in valuing OPEB? Clearly, there will be political issues. If your local community is experiencing increases in taxes (property and school), plus raising money for a school construction bond, then public officials are bracing themselves for the reaction of the community when communicating OPEB numbers plus the annual communication of its fiscal budget (some budgets requiring voting of the community). Reporting the millions (tens or hundreds of millions) of OPEB liability will be a tough one to swallow. The average individual does not understand that this obligation has always been here, and GASB 43/45 is solely the process of recognizing and valuing this obligation. There may be the unfortunate perception that their government officials are spending dollars they do not have.

Bond rating agencies are also going to require this so they can understand the debt obligation of the public entity for entities applying for financing. The employer will have to deal with the challenges of recognizing this number and understanding how to "spin" the results. Actuaries will not only be providing the bad news, but will also be needed for developing the solution.

Now that we have identified the problem, what do we do? Start talking about it with the appropriate parties and develop a strategy. Some organizations have started discussions with employees, in particular during the collective bargaining process. The first reaction of unions during collective bargaining is their retiree benefits will be cut. But it becomes much more important than that, since leaving it alone could result in potential insolvency of the public entity down the road, so the promised benefits might not be there.

Some initial steps to be done for public entities would include getting file documentation in order. This would include locating and clarifying benefit levels, including obligations to retirees. It will also highlight areas with large cost structures, which might require the most immediate attention.

The next step would be to retain an actuary that can assist in valuing the liabilities. Some of the information needed by the actuary to value this benefit includes electronic census information (active and retired employees and dependents), plan design, plan costs (e.g., premium rates, other costs if self-funded), retiree contributions and assets.

What are some of the solutions? Some of the approaches taken include:

- Improved efficiency in managing benefits, including implementing cost containment measures.
- Competitively shopping for benefits (this might mean looking at new insurance carriers or brokers).
- Potential negotiation of benefit reductions for current and/or future retirees (though public sector elimination of these benefits may not be realistic).
- Improving integration of benefits with Medicare so Medicare benefits are exhausted prior to payment on the public entity's plan.
- Increasing retiree contributions for current and/or future retirees.
- Changing eligibility requirements.
- Establishing a special purpose trust like a VEBA may provide flexibility in establishing higher discount rates resulting in lower obligations (1 percent point increase in discount rate could lower liabilities 10 percent to 15 percent—a big number when dealing with $100 million-plus liabilities).
- Creative financing of benefits.
- Retiree buyouts, including selling off the obligations.
- Securitizing of benefits.
- Other solutions unique to a specific employer (larger insurance companies are spending significant energy to develop a solution for these public entities since the magnitude of dollars and opportunity is significant).

These solutions could be applied to legacy benefits or to current or future benefits. Each solution is unique to each organization. However, something will need to be done to manage the cost of future benefits, plus recognizing how these benefits will be funded. When dealing with public entities, the political implications are significant in addition to the dollars and cents, or in this case, tens of millions of dollars.

What not to do as a public entity? Ignore this issue. It is a real problem and needs to be dealt with. Putting your "head in the sand" and hoping it goes away is not prudent and will not work. For those individuals saving for their children's college, you might not be able to fully fund college today, but every little bit helps and developing a plan for funding is important. Public entities will need a game plan and the debt and borrowing market will probably require it.

Because of new medical technology people are living longer, which is a great thing. However, the impact is that liability will only get larger as the baby-boomers all retire and the next generations follow behind them. Tack on the cost of healthcare inflation, which is growing above 10 percent per year, and the risk of not funding or planning for this problem now means the potential for more uninsured people later as future public sector entities cannot meet their obligations.

The OPEB problem is not going to go away. As the population ages and we live longer, this obligation becomes more significant. If we wait for the federal government to solve the problem, then will not be the answer since the likelihood of Medicare coverage being available to ages below 65 will be small with the more likely impact of the government needed to modify Medicare to raise the age limit in the future. These public entities will be looking for actuaries for guidance, though they may struggle with the initial news that the actuary provides, which is the first GASB 43/45 calculations that the actuary provides.

For public entities, some immediate steps would be to discuss with your actuary, benefit consultant, financial advisors and even legal counsel. They can provide some further clarification on solutions available and provide guidance and estimates on current obligations as well as assist in the documenting of these retirement benefits.

Also, for those insurance professionals, such as brokers and benefit consultants, that have spent numerous hours to land a public entity as a client, they should be prepared to attack this issue and be proactive for their clients. Actuaries can provide a role for these individuals.

Michael Frank is credentialed as an actuary and licensed as a broker, reinsurance intermediary and managing general underwriter. For information on his company, please see Web site www.aquariuscapital.com. He can be reached at (914) 933-0063 or michael.frank@aquariuscapital.com.